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January 23, 1995

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street NW - Room 222
Washington, D.C. 20554

RE: Ex Parte Meeting
CC Docket No. 94-1

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Dear Mr. Caton:

On January 23, Mary McDermott, Ed Lowry and Whit Jordan representing the United States Telephone Association (USTA) met with Richard Welch of Commissioner Chong's office. The attached ex parte, filed by USTA on January 18, was discussed.

The original and a copy of this ex parte notice are being filed in the Office of the Secretary. Please include it in the public record of this proceeding.

Respectfully submitted,

Mary McDermott

Mary McDermott
Vice President, Legal & Regulatory Affairs

cc: R. Welch

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	

A USTA PROPOSAL FOR THE LEC PRICE CAP PLAN

Through the LEC price cap review, the FCC can make access customers better off than they are under today's plan, increase the momentum toward a truly competitive market where pervasive regulation is unnecessary, and give LECs a chance (but not a guarantee) of success in this changing market. A properly structured plan can provide additional incentives for the carriers regulated under it to make infrastructure investments.

If the FCC fails to adopt a plan that thoughtfully balances all of these goals, the loser will not only be the local exchange industry. It will be the American public. With this fact in mind, USTA hereby modifies its position in this docket and offers the following comprehensive proposal to achieve the critical balance.

I. USTA'S PROPOSAL FOR A NEW PRICE CAP OPTION BEST ADVANCES THE FCC'S GOALS.

The FCC should permit local exchange carriers to elect a new price cap option in which a moving average automatically adjusts the productivity offset, replacing both sharing and the lower formula adjustment. This new price cap option severs the ties to rate-of-return regulation. USTA has consistently demonstrated that the FCC must take this step. With this new proposal, we add features that make it easy for the Commission to do so.

A. The Moving Average Productivity Offset

In lieu of sharing and the lower formula adjustment, USTA proposes automatically updating the productivity offset via a moving average. This moving average automatically ensures that customers share in any productivity gains realized by the LEC industry. We believe it is appropriate to use a five-year average of LEC Total Factor Productivity with a two-year "lag". Attachment 1 is an in-depth discussion of how the moving average would work as well as the benefits of adopting it. Using a TFP methodology, the offset can be routinely calculated by the FCC itself or by another independent party.

The moving average resolves the problems associated with a fixed productivity offset that does not change to reflect the industry's on-going productivity performance. And because the moving average will rise if, in fact, achieved productivity increases, there is no need for a permanent Consumer Productivity Dividend (<u>see</u> Section B). Indeed, a permanent CPD would result in double-counting of productivity improvements.

B. The Consumer Productivity Dividend and Its "Phase Down"

In the original LEC price cap plan, the Commission included a .5% Consumer Productivity Dividend (CPD) to guarantee that customers shared in the plan's benefits. The CPD did so by delivering anticipated improvements in productivity "up front" to customers. In the new price cap option, USTA proposes including an initial CPD of 1% that would "phase down" as the rolling average mechanism becomes established. (For example, reflecting more of the years when the LECs were under some form of incentive regulation in the federal – and most state – jurisdictions.)

Because new data is automatically incorporated into the moving average, there will be no need to attempt to predict future productivity gains. However, because the moving average contains a 2-year lag, the CPD would continue in Year 2, but at the "phased down" level of .5%. Similarly, in Year 3 of the new option, a .25% CPD would be retained. Beyond the third year, the CPD would be eliminated as the moving average takes over in ensuring that any productivity gains are passed on to customers.

C. One-Time Reduction in the Price Cap Index

In order to immediately share the benefits of the new option with customers, LECs choosing it would make a 1% reduction in their Price Cap Indices (PCIs). It is true that the moving average ensures that the benefits of the plan's productivity incentives are eventually passed on to customers. But USTA believes that an improved price cap plan will benefit customers as well as LECs and so designed the new option to provide some of the expected benefits "up front". With this PCI reduction, as with the CPD, the LECs ensure these customer benefits and assume the risk of actually achieving productivity improvements in the future.

D. Narrowing Exogenous Cost Categories

Another aspect of the current plan that has been controversial is "exogenous costs". As part of formulating our integrated plan, USTA has examined this aspect of the plan and proposes to narrow the categories of costs that qualify for exogenous treatment. We have tried to identify those changes which uniquely affect telecommunications companies and that are the least controversial of the current exogenous categories. This narrower definition of exogenous costs would include only government mandated changes that uniquely affect telecommunications companies and changes in long term support mechanisms (i.e., universal service funding).

II. The FCC Should Adopt An Overall Framework That Allows Carriers To Choose Whether Or Not To Move To The New Option.

In December ex parte meetings, USTA suggested that the FCC maintain a price cap option that essentially embodies today's plan.[1] The non-mandatory price cap companies who elected the current plan have a special concern that a plan no more restrictive than the status quo be available to them. It was under the terms of today's plan that they "elected" price caps. These companies are uncertain of their ability to achieve the scope and scale necessary to sustain productivity gains year after year in line with the industry average Total Factor Productivity (TFP). Retaining a price cap option with a productivity offset no greater than in today's plan -- and both a lower formula adjustment and a sharing component -- addresses these concerns.

A company that subsequently elects to transition from this plan to the new price cap option would use the productivity offset and CPD that are then being used by the other companies in the new option. The company would make the same 1% upfront reduction in the PCI that the other companies in the new option previously made. The company would not be subject to any prior phase down of the CPD because that phase down is designed to ensure consumer benefit during

[1] Only the 3.3% productivity plan would be available. The 4.3% productivity variation would be eliminated.

the transition to the moving average. Once a local exchange carrier chooses the new option, that choice would be permanent.

USTA strongly believes that both price cap options should be available to all LECs. Depending on its particular situation, a "mandatory" price cap company could well decide to stay with the current plan. Every aspect of the plan under which their interstate business is regulated is of vital concern to these carriers because so much is at stake. The unique situation of each carrier is central to its decision of which price cap option to choose.

Allowing price cap LECs to volunteer for the new option would also alleviate the concern that eliminating the sharing and lower formula adjustment mechanisms creates an imbalance in the benefits to price cap carriers versus customers. The concern is that a price cap carrier whose profitability is impaired would too easily be able to obtain "above cap" rate increases even absent the lower formula adjustment. In their comments in this docket and in a USTA ex parte filed on December 12, the price cap LECs have shown that this concern is misplaced. Nevertheless, if the new price cap option is voluntary, there is further assurance that carriers could not easily obtain an "above cap" rate increase on the basis of "confiscation".

III. IN ITS INITIAL PRICE CAP ORDER, THE FCC MUST BEGIN TO IMPLEMENT A REGULATORY FRAMEWORK THAT "ADAPTS" AS COMPETITION INCREASES.

The Commission must adopt a price cap option that eliminates the sharing mechanism, with its ties to rate-of-return, so that true competition in the interstate access market becomes possible. But this is only a first step. Much of the federal regulatory framework for LECs is outdated and stands in the way of allowing the LECs a meaningful chance to compete. For example, the FCC's rules should be changed to include the means to classify particular geographic access markets based upon the degree of competitiveness, and fashion price cap rules that adapt to these degrees of competition. This reform is needed, not only to promote effective access competition, but also to allow the market to guide efficient investment in the NII. Firms considering long-lived investments will naturally take into account how prospective regulation will affect their ability to compete.

In the notice that started this proceeding, the FCC included a number of issues aimed at reforming these and other aspects of its rules governing local exchange carriers. USTA filed a comprehensive proposal in response to the Commission's questions. These issues are just as important as the aspects of the new plan discussed in Section I. However, USTA recognizes that there simply is not time in this phase of the proceeding to resolve these issues fully. We do believe there is ample basis in the current record for the Commission to take some significant first steps in an initial order, including modifications to the price cap baskets and bands, changes to the way new services are treated, and establishment of a data collection program for all access providers. Attachment 2 summarizes our proposal for addressing those issues.

We also recommend that, simultaneous with its initial decision, the FCC issue a further Notice of Proposed Rulemaking and decide the broader issues raised in the initial notice by the end of 1995. Attachment 2 elaborates on this suggestion as well. USTA believes this approach is the best way for the Commission to advance its goal of encouraging access competition and promoting efficient infrastructure investment.

IV. CONCLUSION

The FCC took a constructive step forward in 1990 when it adopted the price cap plan for the local exchange carriers, especially given the state of regulation at the time. But today's plan is no more than a hybrid between rate-of-return and real price regulation. It retains all of the drawbacks of rate-of-return, including cost allocation problems and cross subsidy controversies. Such drawbacks are the reason that rate-of-return regulation in a competitive market is simply unworkable.

There are those who have essentially argued that every dollar of benefit that the LECs have achieved in the "trial" period of price caps should now be taken back as a part of the price cap review. To do so would certainly destroy all of the incentives the FCC worked to create in adopting price caps and leave the LECs without the financial wherewithall to make the necessary infrastructure investments. In contrast, the USTA proposal presented here balances the often competing goals of the parties in a way that best serves the public interest. USTA urges the FCC to adopt a new price cap plan consistent with the proposal set out in this filing.

Respectfully submitted,

UNITED STATES TELEPHONE ASSOCIATION

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January 18, 1995

Moving Average Productivity Offset
LEC Price Cap Performance Review

The LEC price cap plan now uses a fixed percentage productivity offset that is currently under review as part of the Price Cap Performance Review. In lieu of a fixed offset, USTA proposes a 5-year moving average Total Factor Productivity (TFP) growth differential with a 2 year lag[1]. The purpose for adopting a moving average productivity offset is to have price cap regulation more closely emulate the dynamics of a competitive market.

USTA's proposed moving average productivity offset would sharpen incentives by: replacing the sharing and lower formula adjustment backstops with a mechanism that has none of the "rate of return" drawbacks and more closely reflects the workings of the competitive market place. The moving average would be updated annually and would be generated and verified quickly, easily, and mechanically. Annual updates would coincide with the price cap index update in each year's annual filing.

This mechanism would eliminate the need for frequent reviews of the price cap plan. The FCC adopted a relatively short review period of only four years for an initial "trial" of the plan. Frequent review periods dull the efficiency incentives of the firm because of the risk that all efficiency gains may be "taken back" as part of the review.[2] At the same time, with a fixed productivity offset, the risk that it will not reflect the current productivity trend increases the longer the review period.

Key Issues of a Moving Average Productivity Offset

There are several key criteria in selecting the specific moving average productivity offset measure. First, the methodology used should be based on the Christensen TFP methodology as described in USTA's initial comments. Second, the measure should be based on an industry-wide productivity growth. Third, the adjustment should reflect productivity results that adequately smooth the impact of year-to-year swings in productivity, yet still represent the current productivity trend. Fourth, the offset should represent the differential between the productivity gains experienced by the local exchange carrier industry and the overall U.S. economy.

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1. Specifically, USTA proposes that the 5-year LEC TFP differential from the U.S. economy from 1988 through 1992 (2.5%) be used in the annual 1995 Price Cap Tariff Filings. Next year's annual tariff filing would use the average from 1989 through 1993. U.S. economy TFP is not available yet for 1993, but if we use the most recent 5-year average, the number would be 2.6%.

2. Strategic Policy Research, *Regulatory Reform for the Information Age: Providing the Vision*, January 11, 1994, pp. 17-21 [*hereinafter SPR*].

Benefits of a Moving Average Productivity Offset

A moving average productivity offset mechanism would significantly enhance the price cap plan because it would eliminate the uncertainty associated with the current productivity offset and performance reviews and would streamline the process considerably. Many of the concerns raised by parties dealt with uncertainty as to the LEC productivity trend. A 5-year moving average would eliminate these concerns. The productivity offset would be updated annually to reflect the current LEC productivity trend. Therefore, any changes in productivity due to technology changes, competition and entry into new lines of business would be automatically incorporated into the productivity offset.

Using the Christensen methodology for calculating the 5-year moving average would remove the recurring arguments concerning the reopening and resetting of a procductivity offset. No party to this proceeding has a fundamental disagreement with the Christensen methodology for developing the TFP differential. The proposed moving average methodology has been accepted by the ICC for regulating the railroad industry. The railroad industry has been using this methodology since 1989. The Commission and interested parties will not need to spend resources on re-addressing this issue every year.

Annually updating the TFP differential could be mechanized and routine. The LEC TFP could be developed by either the FCC or another Government agency, a consulting firm, or an industry consortium. Most of the data are either taken directly from public sources or derived from them. In the instance of the railroad industry, the TFP is annually calculated by the ICC staff.

U.S. economy TFP is computed by the U.S. Department of Labor, Bureau of Labor Statistics (BLS). The BLS generally updates U.S. economy TFP in October for the prior year.[3]

RATIONALE FOR 5 YEAR TIME PERIOD WITH 2 YEAR LAG

A 5 year moving average with a 2 year lag mirrors the competitive market place, approximates the average business cycle, is equivalent to the time period used by the ICC in regulating the railroad industry, and would be administratively straight forward.

Firms in competitive markets are incented by the knowledge that in the short run all revenue-enhancing and cost-saving innovations will improve their earnings. This incentive is strong in spite of the knowledge that imitations of their innovations by competitors will, in time, cause the benefits of the innovations to be passed on to consumers in the form of lower prices. The proposed 5-year moving average (with two year lag) productivity offset will mirror competitive markets: in the short run each LEC can benefit by innovations, but

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3. However, due to methodology changes by the BLS, the 1991 and the 1992 U.S. economy TFP results were not released until the summer of 1994.

the moving average will ultimately cause 100% of the industry average TFP growth to be passed through to customers via relative reductions in the LEC price caps.

Annual productivity measures are volatile. In part, this is a result of U.S. economy business cycles and industry cycles. Also, some factors of production, such as capital and skilled labor, are not fully variable in times of economic contraction or expansion and thus, productivity is procyclical. Further, many investments tend to be "lumpy"; that is, large investments may be required over a relatively short time while the benefits derived from these investments may not be realized until later time periods.

Ideally, the moving average period should encompass an entire business or industry cycle to include productivity from both "up" and "down" years in the productivity offset. U.S. economy business cycles do not exhibit identical patterns, but vary in severity and duration, lasting from as little as 2 years to about 10 years. These cycles do, however, average approximately 5 years. Therefore, historical patterns of U.S. business cycles are consistent with a 5-year moving average.

The length of the moving average was addressed by the ICC in regulating the railroad industry. Initially, the ICC started with a 5-year average with a 2-year lag. The ICC then added each new year without dropping an old one until an additional 3 years had been added. The result was a growing averaging period of first 6 years, then 7, then 8, with on ongoing two year lag. Recently, the ICC restored the 5-year average as being the most appropriate.

The 5-year moving average with a 2-year lag will be administratively straight forward. Data would be given annually to the party performing the TFP calculation. These data would be taken from public sources such as ARMIS and the LEC tariff filings. Data that are not available from these sources could be obtained from the LECs on a standardized basis through specific reports. Some of these data, such as developing replacement cost and the publication of U.S. TFP data, would not be available in sufficient time to allow for a 1-year lag after the close of the calendar year.[4]

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4. If the BLS U.S. economy TFP were delayed beyond the time frame it was needed for the LEC calculation, the most recent 5-year average for the U.S. economy could be used.

Table 1 below shows the annual percentage changes in TFP for the LECs, the U.S. Private Business Sector, and the differential between them.

Table 1

TFP Growth for the LECs, the U.S. Private Business Sector, and their Differential

Year	(1) LEC TFP Growth	(2) U.S. TFP Growth	(3) TFP Growth Differential
1985	1.1%	0.5%	0.6%
1986	2.8%	1.0%	1.8%
1987	1.8%	0.1%	1.7%
1988	2.1%	0.6%	1.5%
1989	2.0%	-0.3%	2.3%
1990	4.6%	-0.3%	4.9%
1991	1.2%	-1.1%	2.3%
1992	3.5%	1.9%	1.6%

(1) From "Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation, 1993 Update", Laurits R. Christensen, Philip E. Schoech, and Mark E. Meitzen, January 16, 1995.

(2) From U.S. Bureau of Labor Statistics: "U.S. Private Business Sector"

(3) Column (1) minus Column (3)

Table 2 below compares 5-, 6-, 7-, and 8-year moving averages of the annual change in the TFP differential calculated by the Christensen study.

Table 2
Comparison of Moving Averages of Differing Lengths

Year	Annual % Chg. in. TFP Differenti al	5-Year Moving Avg.	6-Year Moving Avg.	7-Year Moving Avg.	8-Year Moving Avg.
1985	0.6%				
1986	1.8%				
1987	1.7%				
1988	1.5%				
1989	2.3%	1.6%			
1990	4.9%	2.5%	2.1%		
1991	2.3%	2.6%	2.4%	2.2%	
1992	1.6%	2.5%	2.4%	2.3%	2.1%

TFP Differential is LEC TFP less U.S. average TFP.

NOTE: LEC total factor productivity for 1993 was 2.6%. U.S. TFP is not available for 1993. The moving averages of TFP differential were calculated as the growth for the most recent 5, 6, 7 and 8 years of data for the LECs minus the growth for the most recent 5, 6, 7 and 8 years for the U.S. economy. The results were 2.6%, 2.5%, 2.3%, and 2.3% respectively.

Attachment 2

Recommended Process for Implementing Adaptive Regulation

USTA believes that reform of the Commission's price cap rules is needed to promote the development of effective competition in interstate access markets, to encourage the introduction of new services, and to allow competitive market forces to guide efficient investment in the NII. These goals can only be achieved if the Commission acts promptly to establish the ground rules for interstate access competition.

In response to the issues raised in the NPRM, USTA has proposed a comprehensive reform of the Commission's price cap and rate structure rules to deal effectively with new services and competition. Recognizing that there is simply not enough time to address the full range of these issues in an initial price cap order, USTA outlines here a plan which would allow the Commission to accomplish the necessary reform in a series of interrelated steps. USTA believes that this entire process could be completed in 1995.

Phase 1 - Initial steps toward reform

USTA proposes that the Commission, in its initial order, should:

- Find that an adaptive price cap framework is in the public interest;
- Adopt those initial steps toward such a framework which are possible in the time frame of the order, given the record already established;
- Issue a further NPRM which would set forth for resolution the remaining elements of an adaptive framework. The order should establish a commitment to resolve these remaining issues in 1995.

USTA proposes that the following first steps could be adopted in an initial price cap order. These changes are designed to be consistent with the long-term framework which would be developed in the further NPRM, so that the steps taken in the initial order would not have to be retraced later. In general, USTA suggests that the initial order deal with those elements of a new framework which do not require specific conclusions regarding the degree of competition in access markets.

a) Basket structure and banding limits should be changed. The structure proposed here would provide some additional pricing flexibility for price cap LECs, and would establish a consistent foundation for the development of an adaptive framework based on competitive criteria.

1) DS1 and DS3 subindices should be eliminated to facilitate efficient pricing of substitutable services. This would provide additional flexibility immediately in hi-cap services -- now one of the most competitive service categories offered by the price cap LECs. This change could provide a transition to the treatment of all digital transport services in a single subindex in the long-term adaptive structure.

2) Lower banding limits should be expanded to minus 15% within the categories. This would allow LECs greater opportunity for competitive response, and would encourage rate reductions which would pass the benefits of competition on to consumers. Aligning all lower band limits at 15% would eliminate the perverse effects of unnecessary constraints in the current structure, which today can actually discourage LECs from meaningfully reducing rates.

3) Zone pricing should be extended to the local switching category. This is reasonable, since local switching, like trunking, is subject to economies of density. This step would also provide a transition toward the consistent treatment of services within a market area in the long-term framework.

4) For the same reasons, zone pricing should also be extended to all elements in the trunking category except the interconnection charge.

b) New service regulation should be streamlined. In order to eliminate the obstacles to new services posed by the current rules, the Commission must adopt a new rate structure to replace the current Part 69 rules; USTA proposes that this be addressed in the FNPRM. However, significant improvement could be realized by adopting the following interim steps:

1) Eliminate Part 69 waiver requirements for the introduction of new rate elements. Rate structure issues for new access services could then be considered in the tariff review process.

2) For new services whose projected revenues satisfy a <u>de minimus</u> test, the tariff review period should be reduced from 45 days to 21 days. A <u>de minimus</u> standard is already applied today to new services of companies operating under Optional Incentive Regulation.

3) The supporting material filed with new services should include

only a showing that the proposed new service covers incremental cost, and therefore that the rates proposed are reasonable. This would allow companies to demonstrate the reasonableness of rates through means other than the allocation of overhead loadings.

c) Minimum reporting requirements should be established

1) In order to ensure that its framework is appropriate for an industry where competition is rapidly growing, the FCC needs data. Therefore, the Commission should require all interstate access carriers to report the areas in which they provide service, and the services provided in each area. This minimal reporting would not be onerous and would provide the FCC with necessary information concerning the availability of alternative access services.

Phase 2 - Adoption of an adaptive framework of regulation

USTA proposes that the initial price cap order should include an NPRM which would tentatively propose an adaptive framework of price cap regulation, and set forth issues which must be resolved in order to adopt such a framework. These issues would include the following:

1) The adoption of a new, more adaptive rate structure to replace the current Part 69 rate elements.

- USTA proposes that this structure should codify only those access elements necessary to carry out specific public policy programs adopted by the Commission. This approach would get the Commission out of the business of maintaining a list of permissible rate elements, would obviate the need for new service waivers, and would allow proposed new services to be judged on their merits, rather than whether they fit into a predetermined structure.

- Price cap LECs would not be required to allocate costs to Part 69 elements, except as needed to determine End User Common Line Charges.

2) The classification of interstate access markets according to the degree of access competition

- USTA proposes that the degree of regulation should be adjusted to match the degree of competition in each access market. Issues to be addressed in the NPRM would include the definition of the appropriate market, the criteria for measuring the degree of competition, and appropriate price cap treatment for each level of competition.

- USTA proposes a system of classification based on market areas, where Initial Market Areas (IMAs) would correspond to the existing pricing zones, Transitional Market Areas (TMAs) would be those with emerging competition, and Competitive Market Areas (CMAs) would be areas where effective access competition has been demonstrated. USTA has developed an addressability standard-based on the availability of alternative supply to customers-for the CMA showing.

3) The development of a revised price cap basket structure

- USTA has proposed the establishment of the following price cap baskets: Transport, Switching, Public Policy, and Other. This arrangement would accommodate new services more readily than the existing basket structure. USTA has also proposed the establishment, within each basket, of Market Area Categories, each of which would be subject to a price cap subindex.

4) Appropriate pricing rules for each classification of market areas

- The NPRM should tentatively propose rules for tariff review which vary depending on the degree of competition in each market area.

- USTA has proposed that CMA areas be removed from price cap regulation - just as competitive AT&T services have been removed. Together with USTA's proposal to adopt a new price cap option without sharing, this would ensure that price caps in IMA and TMA markets could not be affected by events in CMAs.

- USTA has proposed price cap banding constraints, tariff review periods, and new service support requirements for IMA markets, and more flexible price cap rules for TMA markets.

- USTA proposes that contract-based tariffs, similar to those offered today by competitors, be permitted for any service within a CMA, and in response to a customer RFP in a TMA.

Phase 3 - Related Issues

USTA and many other parties have urged the Commission to initiate in 1995 a comprehensive NPRM on Universal Service. The universal service concerns raised in the 94-1 NPRM should be addressed in this separate but parallel proceeding on universal service.

As USTA made clear in its Petition For Rulemaking on access reform (September 1993), *reform of the Commission's access pricing rules is needed for non-price cap companies as well as for price cap LECs.* The Commission should explore the appropriate means for extending the reforms proposed in USTA's Petition to non-price cap LECs. This could be done by including additional issues for comment in the price cap further NPRM, or by opening a separate proceeding.